Hogan Lovells

Investment Protection and Arbitration

Further information

This brochure is a short introduction to investment protection and arbitration and to our practice. If you have any questions about investment protection or how we can help you in making your foreign investment or resolving your dispute, please contact:

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This note is written as a general guide only. It should not be relied upon as a substitute for specific legal advice.

Our website contains the contact details and professional experience and qualifications of all our investment arbitration specialists as well as of the locations and contact details of each our 44 offices worldwide.

Our Investment Protection and Arbitration specialists can speak to you directly in Chinese, English, French, German, Portuguese and Spanish.

September 2011

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Investment Protection

Investment protection promotes foreign investment by reducing the political risks associated with investing capital abroad.

A commitment of capital in a foreign state is subject to the unpredictable risk of loss from unexpected acts or omissions of the host state, particularly when the investment is held over a long period of time. State interference can come in a range of different forms, both intended and unintended, including expropriation, conversion and transfer of assets, non-compliance with permits, or other forms of unfair, inequitable, discriminatory or arbitrary treatment. Where such interference does occur, legal protection in the domestic courts or tribunals of the host state may well not provide an effective or even available remedy.

In order to encourage the investment of foreign capital many states enter into obligations regarding the treatment of investments made by overseas investors, in particular guaranteeing recourse to investors for losses they incur upon the realisation of such political risks. These guarantees are contained in large part in the approximately 2,000 Bilateral Investment Treaties ("BITs") that are currently in force worldwide. There are also a number of multilateral treaties, including chapters of Free Trade Agreements, containing similar obligations. Together these are typically referred to as International Investment Agreements, or ‘IIAs’.

It is a particular and important characteristic of many of these treaties that they entitle an investor to seek recourse for breach of such foreign investment obligations directly against the host state in arbitration before an international tribunal under international law. Such a procedure is often a substantially more effective remedy than relying on diplomatic protection or claims before local courts or tribunals. Most modern BITs include comprehensive investor-state arbitration clauses.

Not all foreign investments qualify for protection. An "investor" must be a national of a state which has an applicable treaty with the host state, and only "investments" in the host state as so defined under the investment treaty will be protected.

This short note explains the basic principles of investment protection. You can obtain further information either at www.hoganlovells.com or directly from our specialists in person by telephone or email (details are listed on the inside cover of this note).

Example (based on a case conducted by Hogan Lovells as lead counsel)

A European engineering company is lead partner in a BIT Tollway concession in an Asian state. Other partners are a construction company from a second European state and a local engineering company. The European investor establishes a local special purpose company to hold and operate the concession and provides 20% of the equity capital. The commercial terms of the concession are negotiated on the basis of assumptions including an expectation of an internal rate of return of about 16%, subject to commercial risks. The construction and operation of the Tollway are negatively affected by government interference, including substantial enhancement of the competing untolled local road network and political interference in the toll regime. After 10 years, the concession company has an accumulated deficit and the projected IRRE is just 5%. Local interests (including a government shareholding) prevent effective enforcement of the terms of the concession agreement.

Because its investment was protected by a BIT, the first foreign investor could bring a claim against the government for the lost value of its investment in its own name before an international arbitration tribunal independently of any right of the local concession company to pursue local contractual remedies. Hogan Lovells successfully represented the investor in these proceedings, achieving a substantial award by way of compensation.

What is an 'Investment'?

Each investment treaty will define what constitutes an "investment". IIAs typically contain a broad definition of various types of assets as well as a non-exhaustive list illustrating the types of investment that are covered by the protection of the treaty.

Often a wide range of capital commitments will be covered, including:

- moveable and immoveable property as well as other property rights such as mortgages;
- investment of capital in local undertakings, whether by way of share or joint venture commitments;
- financing commitments, such as provision of working capital, loans or deferred payments;
- business concessions conferred by law or under contract, including concessions to search for, cultivate, extract or exploit natural resources;
- construction contracts for infrastructure projects such as highways or harbours; and
- intellectual property rights, goodwill, technical processes and know-how.

Not only the principal investment but also collateral elements of a project such as loans and deferred payments will often constitute "investments" in their own right.

Protection in any particular case will depend on the specific contract and the requirements of the BIT in question. Additionally, arbitral tribunals often require that an investment must have the characteristics of longevity, assumption of risk and economic contribution to the host state in order to qualify for protection.

In addition to defining the type of capital commitment, a treaty may impose further requirements qualifying the definition of a protected "investment". For example, some treaties expressly require that an investment must have been made in accordance with the laws and regulations of the host state and sometimes also limit protection to investments that have been specifically "approved" in some form or another by the host state.

Issues may arise when an applicable treaty enters into force after an investment has been made. Many treaties expressly include within their scope of protection investments made before their entry into force. Similarly, most treaties also have run off provisions by which investments made during their currency continue to be protected for many years after the treaty's termination.

Examples

An Omani construction company invested in roadway concessions in Yemen at the invitation of the Head of State. The Yemeni government used duress to force an unfair settlement of the investor's justified claims for additional payment. The investor brought a claim for compensation under the Yemen-Oman BIT. Yemen challenged jurisdiction on the basis that the investor could not produce an "investment certificate", which was stated to be a requirement of the definition of "investment" on the face of the treaty. The tribunal dismissed this challenge, reasoning that the fact that the highest orders of the executive branch (including the Prime Minister and the Ministers of Finance, Planning, and Public Works) had directly negotiated and implemented the concession contracts amounted to an "effective certification" for the purposes of protection under the treaty and that the very nature of the concession contract would satisfy this requirement.

By way of contrast, a tribunal dismissed the claim of a German entity that had invested in a company that held a concession to construct and operate a new international airport terminal in the Philippines. The dismissal was on the basis of their finding that the investment had been made in violation of the Philippines' foreign control laws.

(This award has very recently been annulled.)

Who is an 'Investor'?

Only "investors" within the meaning of the applicable investment treaty can rely on its protection.

Generally all natural and legal persons that possess the nationality of another contracting state can be considered as "investors" for the purpose of the treaty. The investor must have the nationality of a state other than the host state.

Determining nationality requirements is usually straightforward in relation to natural persons. In relation to legal persons it can be more difficult, particularly where complex holding structures are involved. Treaties vary according to whether they take place of incorporation or management as the defining criterion. Some treaties impose additional requirements of substantial connection or control. An investor is well advised carefully to review the structure by which it makes its investment so as to take account of the possibilities and restrictions of such protection as may be available to it.

Protection at the outset does not guarantee protection throughout the term of an investment: assignments, reorganisations, mergers and changes of status can each give rise to additional considerations regarding the criterion of nationality.

Example

In the example on page 1, the second European investor has no claim under international law because there is no investment treaty between its and the host state. Had it been aware of this when making its investment, the investor might have been able to protect its investment by structuring it indirectly through a third state that had entered into a BIT with the host state.

An example where an investment held indirectly through a third state has been held to be protected is the 2009 arbitral award in the case of Tza Yap Shum v. Peru. The claimant was a Hong Kong citizen with Chinese nationality. He issued proceedings against Peru under the China-Peru BIT, claiming compensation for the alleged expropriation of his Peruvian fish flour company. Peru challenged jurisdiction on the basis that the claimant had structured the holding of his investment in Peru through a holding company in the British Virgin Islands. The tribunal upheld jurisdiction on the basis that the Chinese investor was by far the majority shareholder in the only intermediate company that separated him from the investment and was therefore able to call on the protection of the China-Peru BIT.

Substantive Guarantees of Protection in Investment Treaties

Investment treaties usually constitute the primary source of international law obligations regarding foreign direct investment in a state. The contractual and administrative law documents defining an investment will often be influential in defining the rights attaching to that investment but they will not be determinative of the host state's obligations under international law. This is because the protection afforded by treaties exists independently of the municipal law which governs a project or other investment and falls to be construed under international law.

The substantive guarantees of protection will be defined by the wording of the particular treaty. Nonetheless, there is a considerable degree of conformity both within and between regions. Not least, most treaties contain a so-called "most favoured nation clause" by which the host state assumes an obligation to treat investments of investors no less favourably than it treats those of investors of third states. This clause has the effect of importing guarantees from investment treaties entered into by the host state with other states where they are more beneficial to the investor.

A central feature of almost all investment treaties is an express guarantee that expropriation of investments may only take place for public purpose, in a non-discriminatory way and against payment of adequate compensation. Such clauses generally offer protection not only against direct expropriation but also for measures that are "tantamount" to expropriation: that is where state measures have factually deprived an investor of the economic value of an investment without a loss of legal title.

A further common guarantee is that of fair and equitable treatment of the investment. The purpose of this guarantee is to define a standard of treatment for foreign investors independent of the domestic law of the host state. This guarantee is often accompanied by protection against arbitrary and discriminatory treatment. Some modern BITs, notably the current USA model BIT, have moved back to a lower level of protection tied to the minimum standard of treatment under customary international law.

Example

A Spanish company invested in two hazardous waste landfill companies in Mexico. The Mexican authorities refused to renew the operating licences. The Spanish investor brought an investment treaty claim against Mexico arguing that the authorities' decision not to renew the licences had been arbitrary and unsubstantiated and had resulted in depriving its investment of any continuing value. The tribunal held that the non-renewal of the licences amounted both to a de facto expropriation (i.e. the investor had been effectively deprived of its ownership) and also to unfair and inequitable treatment. It defined the fair and equitable treatment standard in terms of the foreign investor's "legitimate expectations": that is, the basic expectations that had been taken into account by the foreign investor to make its investment. (The award of compensation in the example on page 1 of this note was based on this same standard).

Investment Arbitration Proceedings

In most modern investment treaties the state parties consent to arbitrate investors' claims arising under the treaty directly with the foreign investor itself as a party. This is an important and powerful right for investors since it means that if a host state breaches its obligations the investor can itself bring a claim before an international arbitral tribunal in its own name and under international law without having to rely on diplomatic protection or local procedures.

Such ‘investor-state’ proceedings are similar in many ways to international commercial arbitrations save that they fall to be determined by public international law and are subject to the political implications of state participation. These additional attributes raise particular issues in relation to the commencement of proceedings, the qualifications and other qualities required to be considered in the selection of the arbitral tribunal, frequent objections by the state party to the jurisdiction of the arbitral tribunal, political sensitivities in certain aspects of the conduct of the case and a rapidly developing and extensive global jurisprudence.

The procedural possibilities offered in investment treaties comprise those already available and familiar in international commercial arbitration: namely ad hoc arbitration (with or without the incorporation of the UNCITRAL Model Rules) or institutional arbitration (e.g. ICC, LCIA, SCC). In addition, many treaties also offer submission to arbitration under the rules of the Convention on the Settlement of Investment Disputes between States and Members of Other States ("ICSID Convention").

The ICSID Convention enjoys widespread acceptance and has been ratified by over 140 states. It provides a forum created specifically and exclusively for the conduct of investor-state disputes concerning investments. ICSID proceedings are independent from domestic legal systems and governed only by international law and the relevant ICSID rules. The ICSID Convention provides for a stand-alone annulment procedure. This takes place before a special ad hoc committee in place of the normal process of challenge before a national court. The ICSID Convention also contains a simplified enforcement procedure.

The most common remedy in investor-state arbitration is an award of compensation. In general terms, this is assessed as the amount that would place the investor in the position that it would have been in had the host state not breached its substantive guarantees of protection.

Investor-state arbitral awards are commonly honoured without the need for enforcement. The high level of compliance with such awards can be attributed to the facts that they constitute international law obligations in themselves and that their non observance may prejudice the host state's credit-worthiness in international financial and insurance markets. In addition, ICSID awards have a special status: ICSID’s affiliation with the World Bank brings with it the possibility that non-performance may lead to the withholding of World Bank loans and lends particular effectiveness to such awards.

Comment

As of 31 December 2010, ICSID had registered 331 cases under the ICSID Convention and Additional Facility Rules. A quarter of these cases have concerned the oil, gas and mining sector, 14% the electric power and other energy sector and 11% transportation. Finance has accounted for 7% of claims, water, sanitation and flood protection 7% and construction also 7%. ICSID provides a useful twice-yearly statistical report on its website: http://icsid.worldbank.org.

Investment Guarantees and Political Risk Insurance

The existence of an international investment agreement such as a BIT can play a critically important role both in a company's decision to make an investment abroad and in its ability to make that investment.

First, it may be a decisive factor in an investor's evaluation of risk and profitability through its provision of an essential supplementary legal protection in the case of a perceived inadequacy, unfairness or ineffectiveness in the host state's domestic legal framework. It also increases the likelihood of political support from the investor's home state upon the first occurrence of political interference by the host state.

Second, the existence of an IIA may be decisive to the investor's ability to obtain financing. The existence of a bilateral investment treaty may itself be a prerequisite to the granting of an investment guarantee or export finance under a state-sponsored scheme. Similarly, the existence of an IIA is likely to affect the availability and the cost of political risk cover on the commercial market. The terms of cover too will typically reflect the scope and level of protection under the applicable BIT. The availability of an investment guarantee, political risk insurance or export finance may in turn play an essential part in an investor's ability to assemble an adequate debt and equity financing package as a whole.

The primary function of at least some state sponsored schemes is to provide political support to the investor with the goal of resolving threatening risks and ensuring the continuance of the investment and thus the avoidance of an incident of loss. Should such attempts fail and a claim ensue the state will be interested in recovery from the host state in its own right. For this reason BITs typically contain a provision expressly obliging the host state of the investment to recognise the subrogation of the investor's rights under the BIT to the home state. Less commonly a treaty might also recognise a right of subrogation generally. The terms of commercial political risk cover should in any event ensure that the investor's rights to protection of its investment under the applicable IIA are not lost by reason of assignment or subrogation, in the same way that investors should have regard to preserving their own rights to protection in the context of reorganisation and M&A activity as mentioned on page 4 above.

Example of a Treaty Provision Preserving a Home State's Subrogated Interest

"If one Contracting Party or its designated agency makes a payment to its investor under a guarantee given in respect of an investment made in the territory of the other Contracting Party, the latter Contracting Party shall recognize the assignment of all the rights and claims of the indemnified investor to the former Contracting Party or its designated agency, by law or by legal transactions, and the right of the former Contracting Party or its designated agency to exercise by virtue of subrogation any such right to the same extent as the investor. … "

(Article 7 of the German-China BIT of 2003)

Example of a Treaty Provision Preserving a General Subrogated Interest

1. If the investments of an investor are insured against non-commercial risks, any subrogation of the claims of the investor pursuant to this Agreement shall be recognised by the other Party.

2. Disputes between a Party and an insurer shall be settled in accordance with the provisions of [the investor-state arbitration clause in] this Agreement."

(Article 22 of the Draft Norwegian Model BIT of December 2007).

The New Foreign Direct Investment Regime in Europe

New Legal Framework

The European Union took over exclusive competence in the area of Foreign Direct Investment (‘FDI’) from its Member States upon the coming into force of the Treaty of Lisbon on 1 December 2009. FDI now forms part of the EU's Common Commercial Policy (per Article 207 of the Treaty on the Functioning of the European Union, 'TFEU'). This means that the EU alone may legislate and adopt legally binding acts and that the Member States themselves no longer have power to do so unless specifically empowered under EU legislation.

It is likely that legislation will be passed by the European Parliament shortly to clarify the position of the more than 1,000 existing international investment agreements between Member States and third states as well as the small number of treaties currently in negotiation or renegotiation or undergoing ratification.

Another important change brought about by the Treaty of Lisbon is that future EU IIAs may be concluded only with the consent of the European Parliament and within a framework laid down by the Parliament and the Council within the context of the principles and objectives of the Union's external action.

The negotiation of EU IIAs with third states will be conducted by the Commission in consultation with a special committee appointed by the Council for this purpose.

‘Foreign Direct Investment'

One surprising aspect of the transfer of competence is that there is not yet any firmly established meaning of ‘Foreign Direct Investment’ for the purpose of defining the scope of the EU's new exclusive competence under the Common Commercial Policy.

It is probable that the starting-point will be the definition that has already been established in the context of the free movement of capital. Here it is understood to mean "investments of any kind made by natural or legal persons which serve to establish or maintain lasting and direct links between the persons providing the capital and the undertakings to which that capital is made available in order to carry out an economic activity" and which allow the investor "to participate effectively in the management of that company or in its control".

That leaves the distinct possibility that so-called ‘portfolio investments’ – i.e. passive holdings without active management control - may not fall within the scope of the EU's exclusive competence under the Common Commercial Policy. If so, such investments would continue to be covered by the provisions on the freedom of capital movements and thus in principle would be a matter of shared competence between the EU and the Member States as part of the internal market. This in turn raises the question whether future IIAs covering both Direct and Portfolio Investments will require to be so called ‘mixed agreements’ (i.e. agreements concluded by both the EU and the Member States) or whether the EU may conclude such agreements on its own. There are currently divergent opinions on this question. It also raises the question whether Portfolio Investments will be sought to be covered at all.

Some also continue to question even whether the scope of the Common Commercial Policy extends to post-admission issues (notably investment protection) at all, particularly in relation to expropriation. There is an increasing body of opinion in favour of the view that the EU's competence does indeed extend to such matters and this is certainly the basis upon which the Commission is itself proceeding.

Investor-state Arbitration

Another important issue that remains to be resolved following the transfer of competence is whether EU IIAs will contain investor-state arbitration and, if so, in what form. Assuming that the principle of investor-state arbitration will be maintained (as seems likely), one particular matter that will have to be addressed is that the EU is not and cannot be a party to the ICSID Convention (see page 5) since it is not a state. It follows that it may not consent to the referral of investment disputes to ICSID arbitration and that disputes must be referred to other fora.

Hogan Lovells' International Trade and Investment Practice

Risk Assessment

The Hogan Lovells' International Trade and Investment team can assist business and government right from the outset of a project. Our comprehensive practice includes advice on market access and regulatory requirements on new investments, and advice on structuring investments and about contract, corporate and compliance issues during the course of your project. Hogan Lovells works closely with governments and investment guarantee agencies and is active in policy formation concerning the legal framework of foreign investment. We also advise governments on drafting and negotiating BITs and managing the risk of investment claims in the implementation of government policy.

Doing the Deal

Hogan Lovells' strong presence in the world's major financial hubs and our experienced team of over 400 M&A lawyers enables us to structure, negotiate and implement highly complex cross-border transactions. During the past three years we have advised on more than 900 merger and acquisition transactions, with a total value exceeding US$535 billion.

Safeguarding Business Operations

Some of the most difficult challenges of investing abroad arise after the investment has been made. The investment may invoke host country laws regulating operations in third countries, such as foreign policy boycotts, economic sanctions or anti-corruption and anti-terrorism laws. Competitors may bring protectionist trade actions to interrupt the investor’s flow of goods into the country or allege violations of intellectual property rights or competition laws. The investor may encounter unforeseen difficulties in obtaining regulatory approvals, or obtaining approval for critical personnel to work in-country.

Hogan Lovells’ extensive practice in government regulation and government affairs features lawyers with years of government service and private practice. Our experience in international trade disputes and trade compliance is coupled with sector-specific regulatory expertise in many critical areas: energy, media and telecommunications, life sciences, aerospace, defence and government services, transportation, environment, intellectual property, agriculture and food. This sector focus ensures in-depth familiarity with the legal challenges faced by an investor’s specific industry.

Investment Arbitration

Investment arbitration requires specialist knowledge and experience. Such proceedings have all the complexity of the largest international commercial arbitrations but also the additional demands brought by a combination of the public international law components and the political implications of state participation.

Hogan Lovells' Investment Protection and Arbitration practice is a closely coordinated international group of our dispute resolution lawyers specialised in conducting international law disputes in the field of investment protection.

By their nature, investment disputes tend to concentrate around particular types of international investments, including energy, transportation and other infrastructure projects, privatisations and, increasingly, financial services. By reason of regional, political or economic developments they may also concentrate in particular regions at any one time. Our presence in all the major global business centres, our far-reaching network of professional and academic contacts and the depth and breadth of our experience in numerous jurisdictions enable us to conduct international law proceedings anywhere in the world. Our team is international and interdisciplinary: we operate not only across practice streams but also across all our offices.

Our dispute services cover:

- devising and implementing strategies for parties in investment disputes;
- effective project management and party representation in investment arbitral proceedings (including choice of tribunal, procedural conduct, pleadings, commissioning and presentation of factual and expert evidence, oral and written advocacy and negotiation); and
- enforcement of arbitral awards and defence of unjustified enforcement attempts.

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Hogan Lovells has over 2500 lawyers operating from 44 offices in the world's leading financial, commercial and political centres. Its operations are structured by reference to five strong practice groups:

- Litigation, Arbitration & Employment
- Corporate
- Finance
- Government Regulatory
- Intellectual Property.

Hogan Lovells is recognised as one of the leading international law firms for major dispute resolution work. Our practice comprises over 700 litigators and is unmatched in terms of its size, international reach and breadth of experience. The international arbitration practice has been recognized as one of 100 leading specialised practices in the world by the Global Arbitration Review (GAR). Two thirds of our lawyers are mentioned in leading directories around the world. Hogan Lovells is marked by a strong citizenship commitment including pro bono advice and a diversity policy.

www.hoganlovells.com

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